DENTONS

The Name is Bonds. Thematic Bonds.

What’s next for the sustainable debt market?

Grow | Protect | Operate | Finance

December 2023

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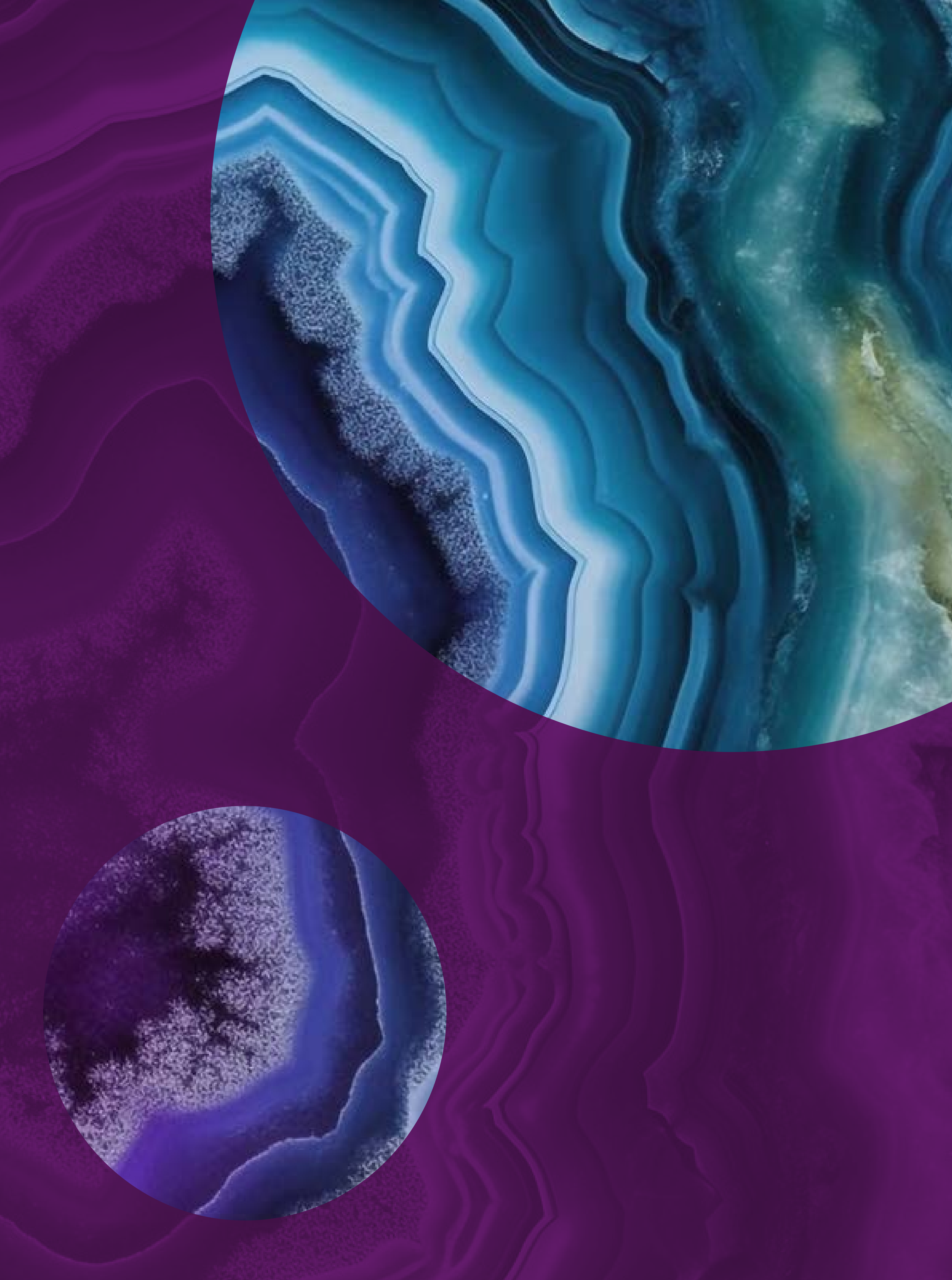


Introduction

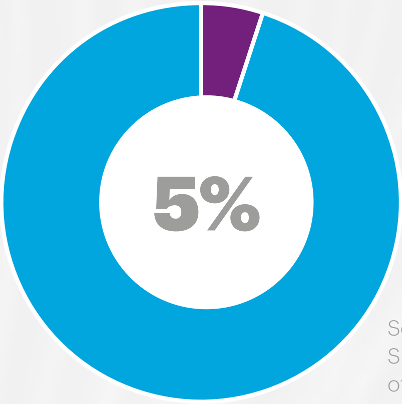
In 2023, Ecuador laid a milestone in the world of sovereign finance: the greatest debt-for-nature swap in history. Ecuador's commitment to the protection of Galápagos Islands in exchange of sovereign debt refinance – at an unprecedented scale – could provide a necessary impulse for other actors. Now, did Ecuador prove that money does grow on trees or, more precisely, that it can be *naturally sourced*?

That may be up for debate, but humanity will certainly need more nature-oriented, innovative, accessible financial instruments and agreements in these challenging times. The world had not yet fully emerged from the gloom of the pandemic when the conflict between Ukraine and Russia broke out – adding an energy crisis, a possible food crisis, and a turbulent geopolitical conundrum to the post-covid slowdown.

Plus, the climate catastrophe remains as urgent as ever, the most disadvantaged regions of the world being also the most exposed ones. As the temperatures climb, so do expenditures. The low-carbon transition alone requires an investment of $4-6tn a year (COP27 estimates). Countries are increasingly looking for ways to diversify their financing sources.

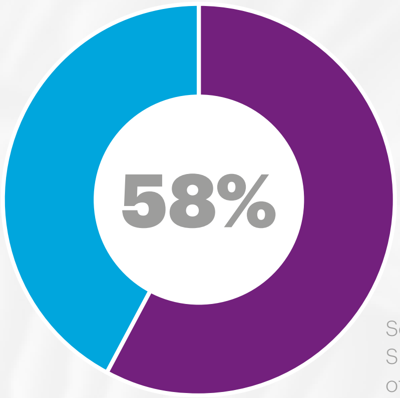
To the rescue – the sustainable debt that has emerged to plug the funding gap and address the pressing issues of the 21st century. However, the market is still maturing. Fortunately, as much as sovereigns need money and diversification, investors have also come to recognize the value of preserving biodiverse forests and clean oceans. What options are available for those ready to protect nature's capital?

Thematic bonds vs. global debt market



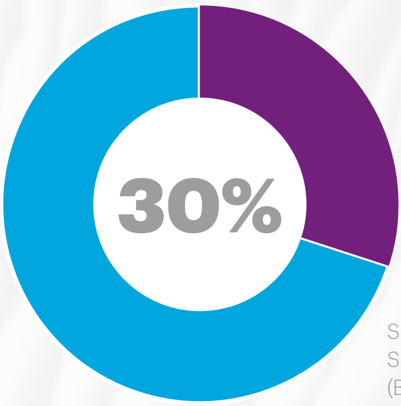
Source: Climate Bonds Initiative, Sustainable Debt. Global State of the Market 2022

Share of green bonds in the global thematic market



Source: Climate Bonds Initiative, Sustainable Debt. Global State of the Market 2022

Public actors' share in thematic issuances to date



Source: World Bank, Green, Social, and Sustainability (Bonds Market Update – January 2023. Includes sovereigns, government agencies and development banks, regional and local governments

Executive summary

- **Low-carbon transition, nature preservation and climate risk adaptation all require significant funding**. Investment needs will only grow bigger, moving sustainable debt instruments to the forefront.
- **Thematic bonds and other sustainable finance mechanisms are many and varied,** with green bonds being the most popular ones (over half of 2022 issuances).
- **Sustainable debt of today is a fraction of the global bond market:** about 5% as of 2022.
- **Emerging economies** see thematic bonds and debt-for-nature operations as a way to diversify their investor base and open alternative funding lines.
- **Social bonds could help sovereign issuers in future emergencies.** These bonds saw significant growth during the COVID-19 pandemic.
- **Climate risk adaptation and biodiversity preservation are gaining prominence** as key investment areas: massive funding will have to go to climate-related disasters and adaptation efforts in the near future.
- **Challenges for thematic bonds** include high issuance costs, complex processes, and difficulties in identifying eligible projects, highlighting the need for improved governance, reporting and standardization.
- **Governance and reporting standards are not fully set,** with voluntary guidelines becoming the de-facto standards promoted by ICMA and TNFD.
- **Ecuador's debt-for-nature swap – the greatest in history – sets a milestone** in sustainable debt and nature-oriented financial instruments.

Thematic bonds explained

Sustainable debt instruments – that is thematic bonds – are the keystone of sustainable finance. The bonds are known under several names: use-of-proceeds bonds, GSS+ bonds, impact bonds… All these monikers describe fixed-income securities that earmark proceeds for projects and activities related to a specific ESG theme.

Examples include (but are not limited to) projects related to climate change, education, affordable housing, marine conservation, or projects that fall under the scope of the UN Sustainable Development Goals.

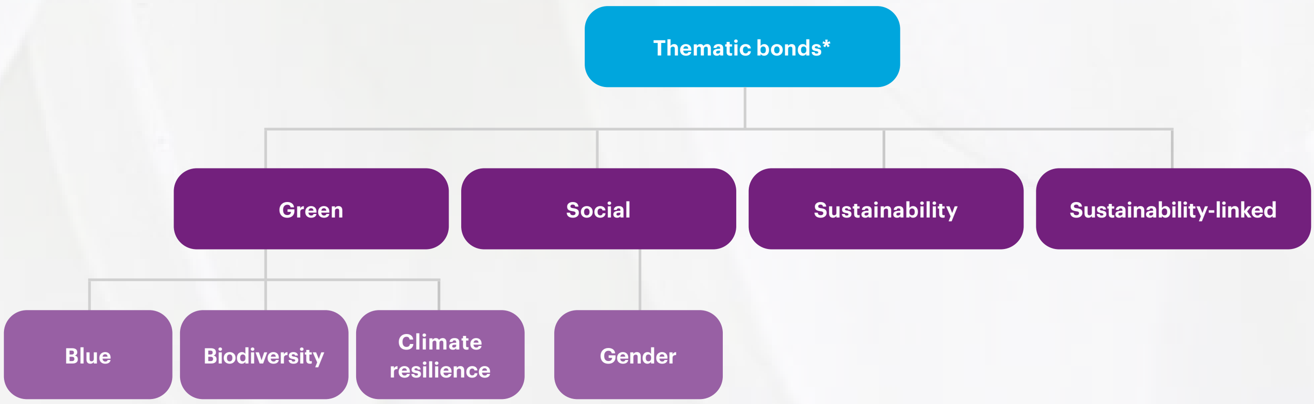
The **issuance process** usually goes like this: an issuer discloses the types of projects to be financed and the processes established to identify eligible assets and expenditures, then tracks the allocation of bond proceeds, and then reports that allocation to eligible projects, as well as the environmental or social impact of the projects supported.

The work on standardized, international procedures is still ongoing. There are no binding regulations, but issuers can resort to the principles developed by the **International Capital Markets Association** (ICMA).

These voluntary guidelines have become the de-facto global standards. For example, when it comes to green bonds, 98% of international issuances in 2021 were aligned with ICMA's Green Bond Principles.

As per the definitions that have been established at this early stage of the market development, the World Bank qualifies as "thematic" the bonds that are labelled **green, social, sustainability, and sustainability-linked.** Some sources, for example, the Climate Bonds Initiative, also include transition bonds in the sustainable debt toolbox.

Main types and subtypes of thematic bonds



** Also known as: GSS bonds, GSS+ bonds, impact bonds, labelled bonds*

The most popular category by far (58% of total thematic issuances in 2022)[1] are **green bonds** – with the proceeds going to projects with a positive environmental impact. **Blue bonds** are a new subcategory of green bonds, and they are used to finance projects related to sea and ocean conservation.

Social bonds raise funds for projects with expected positive social outcomes. **Gender bonds**, a subcategory of social bonds, focus on a plethora of projects encompassing gender equality promotion.

Sustainability bond proceeds support a combination of green and social projects or activities.

Sustainability-linked bonds do not earmark proceeds for specific projects or expenditures. Instead, the issuer commits to meeting predefined KPIs within a timeline. The KPIs can be either environmental or social objectives; they must be verifiable and ambitious. If the target is not met, the investor is typically compensated monetarily via a **coupon step-up**, which presents a particular risk in the case of sovereigns.

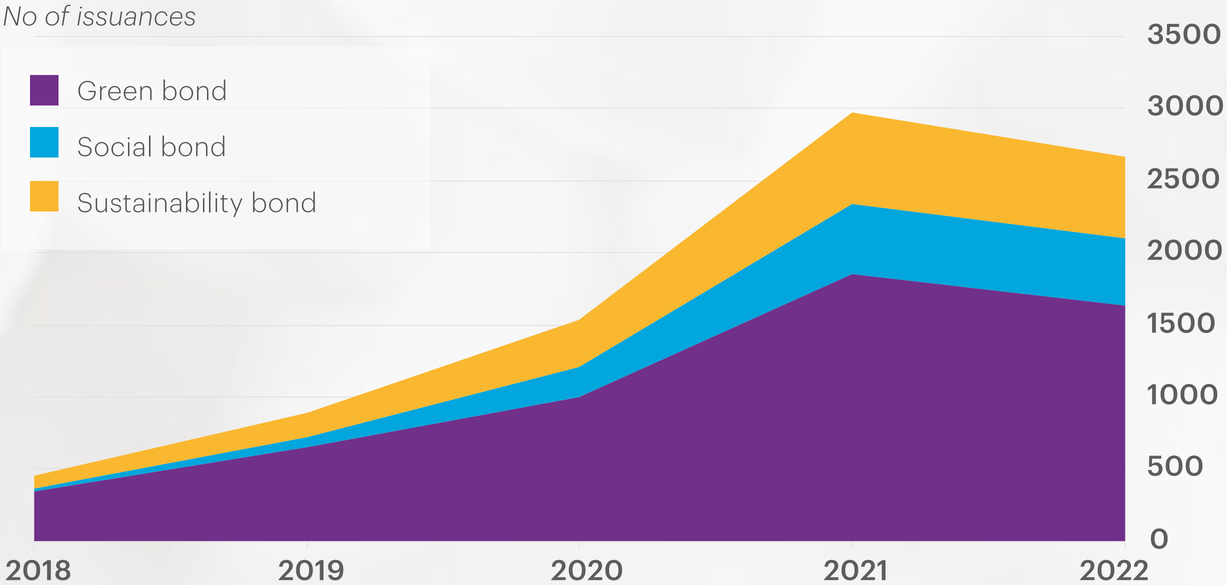
Thematic bonds can also be used in debt restructuring mechanisms, such as **debt-for-nature swaps**, which consist of forgiving some part of the debt in exchange for investment in conservation or other activities related to sustainable development.

The mechanism emerged in the 1980s, but it remained a niche. Originally, the debt would be purchased by a conservation organization. In the more recent transactions, debtors brought back existing bonds at a discount and issued a new thematic bond, pledging to allocate the savings into conservation efforts.

For more details, see the featured description of the record swap sealed in May 2023 by the Republic of Ecuador, which was advised by Dentons' Sovereign Advisory practice (p. 12).

Impact bonds issuance by type

No of issuances



Source: ICE, Impact Bond Analysis. Certification grows amid regulatory scrutiny, 2022

Thematic bonds – notable examples

Green bonds

In **March 2021**, the Italian Ministry of Economy and Finance issued its first green bond in line with its "Framework for the Issuance of Sovereign Green Bonds" published the month previous. The €8.5 billion bond, maturing on April 30, 2045, saw demand in excess of €80 billion – making it the biggest debut sovereign green bond from a European issuer to date. Its purpose was to support Italy's environmental goals by financing initiatives, ranging from energy efficiency to transport, from circular economy to biodiversity.

Blue bonds

May 2023 – Indonesia launched a yen-denominated blue bond issuance worth ¥104.8bn ($757m). The issuance consists of four tranches, and two of them – with seven-year and ten-year maturity – carry blue labels. The transaction was one of the few blue bonds issued in the Asian markets so far. The first one was the sovereign blue bond sold by the Republic of Seychelles. The government will invest an amount equal to the net proceeds into eligible projects under the country's Sustainable Development Goals Government Securities Framework.[2]

Social bonds

Sep 2022 – IDB Invest, a member of the Inter-American Development Bank Group, issued a three-year social bond in Mexico worth 2.5bn Mexican pesos (approx. $125m). The proceeds from the issuance were allocated to projects aimed at improving financing conditions for micro, small and medium-sized enterprises in Latin America and the Caribbean. The bond was listed on the Mexican Institutional Stock Exchange and was very well received by Mexican investors.[3]

Gender bonds

Nov 2022 – Kyrgyzstan issued its first-ever gender bonds. Several institutions partnered up to make it happen: UN Women Kyrgyzstan, Bank of Asia, Institute for Economic Policy Research of the Kyrgyz Republic, Astana International Financial Center's Green Finance Center, Kyrgyz Stock Exchange, and financial company Senti. The total value of the issuance was 82m Kyrgyzstani som, and 25% of 82,000 bonds were purchased within the first half hour of trading. The initiative is focused on female entrepreneurs from suburban and rural areas in Kyrgyzstan.

Sustainability bonds

Jan 2023 – The Republic of Slovenia issued a €1.25bn, 109-year sustainability bond. The proceeds will be used to fund government investments supporting social and environmental aims set out in the Slovenian Development Strategy 2030, including but not limited to the transition to a low-carbon, circular economy – the green aspects – and advancing the work on social goals in the areas of housing, education, and healthcare – the social aspects.[4]

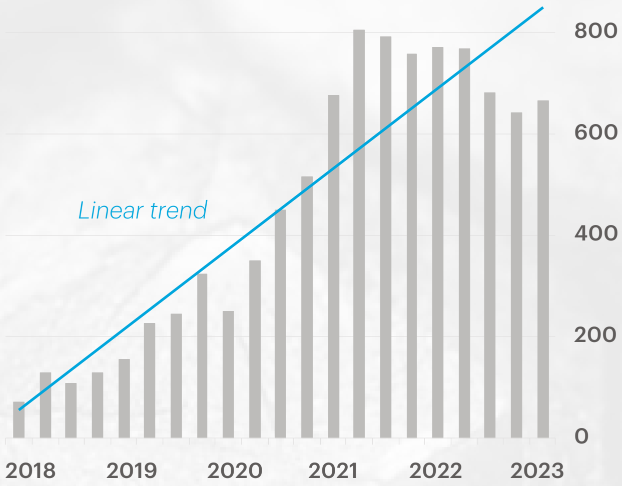
Sustainability-linked bonds

Mar 2022 – Chile became the world's first-ever issuer of a sovereign sustainability-linked bond (SLB). The offering consisted of a $2bn, 20-year SLB with two KPIs: reducing greenhouse gas emissions to a specified target value and increasing Chile's use of renewable energy to 50% by 2028 and 60% by 2030. If the targets are met, the coupon price will remain unchanged. If the country fails to deliver on the KPIs, a 12.5 bps coupon step-up will occur.[5]

Sustainable debt set to gain steam

Thematic bonds – quarterly issues

No of issuances, last 5Y and Q1 2023



Source: ICE, Impact Bond Analysis. Certification grows amid regulatory scrutiny, 2022

Financial institutions discussing thematic bonds during their events

% of meeting transcripts mentioning thematic bonds, last 5Y

Source: Dentons' analysis based on AlphaSense

Sustainable debt may constitute just a fraction of the global bond market– the Climate Bonds Initiative puts the number at **5%** (share of new debt volume in 2022)[6] – but for the last five years, it has been gaining momentum and, so far, demand has been surpassing supply.

In the last 5 years, thematic bonds have grown exponentially. In 2018, the global volume of sustainable issuances barely exceeded $200bn. In 2022, it reached $858.5bn, bringing the cumulative volume to $3.7tn.[7] In H1 2023, $448bn worth of sustainable debt was issued, as per Climate Bonds Initiative (CBI). 2022 was the first year in history when sustainable debt issuances slowed down, but it was in line with the overall downward trend in debt capital markets. The H1 2023 result is 15% down y/y, but it is more than half of the value of thematic bonds that CBI recorded in 2022. Symbolically, deals supporting low-carbon energy amounted to more than those originating from fossil fuel companies in this period.[8]

Most analysts agree that sustainable issuances are set for a **rebound** and **more growth**.[9] [10]

There seems to be a consensus that **sovereign issuers** are set for an upward trajectory. Considering the scale of issues that need to be addressed—including energy transition, climate adaptation, social inequalities, etc.—combined with the limited GDP growth, countries need to **diversify** their investor base. The first half of 2023 saw record activity from sovereign issuers, as they added $74.8bn of sustainable debt to the market (+35% y/y). Five of the twenty sovereign issuers in H1 2023 issued debut deals (Israel, India, Malaysia, UAE, and Cyprus).[11]

Indeed, it is by far the first benefit that debt management offices see in thematic bonds, as revealed by a survey carried out in 2022 by the World Bank (Sovereign Green, Social and Sustainability Bonds: Unlocking the Potential for Emerging Markets and Developing Economies). This is particularly important for emerging countries. With thematic bonds, they can now reach investors that might not be willing to credit them conventionally. What may come as a surprise is that the broadly discussed 'greenium' – i.e., the green premium, or pricing benefits attached to sustainable debt – is not the primary driver for sovereign issuers.[12]

The momentum is strong on the **demand** side, too. Investors are under pressure from regulators and stakeholders to boost their ESG commitments. Including thematic bonds in their portfolios is a way to achieve that.

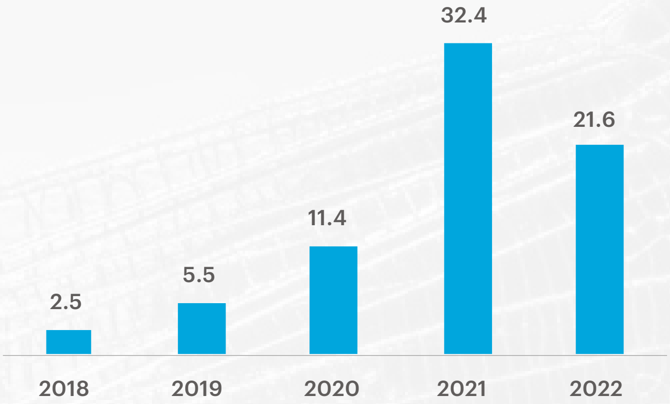
The investors surveyed by the World Bank expressed interest in **emerging sovereign bonds**, because they see sovereign issuances as a way to set good **standards** and **develop ESG markets** by motivating more issuers. In 2021 – the best year for thematic bonds so far – sovereign issuers from emerging countries issued thematic bonds worth $32.4bn, which meant a triple year-on-year increase. In 2022, these markets recorded a decline in line with the rest of the debt market, but the end-of-year figure was still nearly two times higher than in 2020 and nearly four times bigger than in 2019.

Interestingly, the breakdown by type is **different** than in more mature markets. While sovereigns in the advanced markets focus on green bonds (94% of the total amount issued), emerging countries focus more on **sustainability** bonds, combining the environmental and social impacts (43% of the total issued vs 27% of green bonds).[13]

The trends confirm that sovereign issuers do see the potential – 24 of the 32 debt management offices from emerging markets surveyed by the World Bank are considering a thematic bond issuance – but thematic bonds are still not the silver bullet.

Sovereign thematic bonds in emerging markets

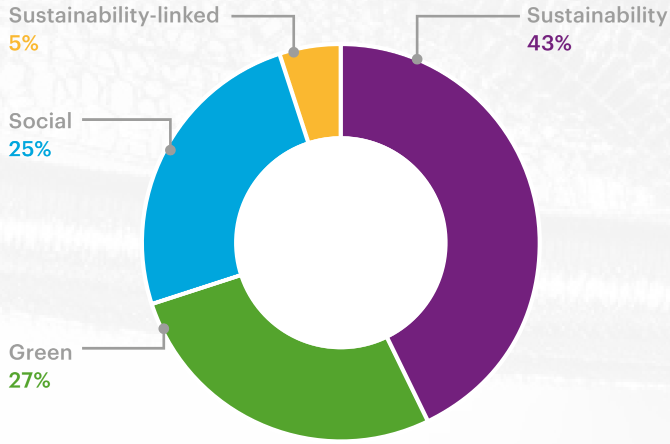
Volume of issuances, $bn, last 5Y, source: World Bank based on Bloomberg and Bloomberg NEF



Source: World Bank, Green, Social, and Sustainability Bonds. Market Update – January 2023.

Sovereign bond types in emerging markets

% of total issuances, source: World Bank based on Bloomberg and Bloomberg NEF



Source: World Bank, Green, Social, and Sustainability Bonds. Market Update – January 2023.

Challenges ahead

Temptingly, thematic bonds offer increased **access to debt**. But more accessible debt is still **not free of charge.** S&P Global predicts that developing countries—those that are most likely to use innovative debt instruments, particularly the sustainability-linked ones—cannot sustain all the debt they would ideally like to use. This group of sovereigns will also have to absorb the **heaviest material losses** relative to the changing climate, which can only reduce their resilience, economically and otherwise.[14] Meanwhile, the external debt of emerging market countries has increased by almost 65% in the last decade.[15]

Additionally, all these instruments – be it green, blue, social, sustainability, sustainability-linked or swaps – are **complex products.** Complex means expensive in transaction and hard to monitor.

Indeed, the cost of issuance is the primary barrier that sovereign issuers cite in the World's Bank 2022 survey,[16] followed by complicated processes and difficulties in identifying eligible expenditures. These issues are aligned with the top challenges perceived by investors, i.e., weak bond frameworks and lack of institutional capacity to identify and monitor eligible projects.

Governance and reporting are indeed the true pain points of modern bonds, especially in countries that do not have sufficient institutional capacity to create robust frameworks and oversee compliance.

However, the work to standardize sustainable finance and prevent greenwashing is ongoing, which can help address some of these challenges. In 2023, the European Union reached a political agreement on the European green bond standard, which will constitute a voluntary framework, not a mandatory one, but it does show the political will to bring more rigor to the market.[17] We can soon expect additional guidelines from the Climate Bonds Initiative, which is working on expanding its standard to allow for certification of SLBs, hoping to address the concerns over potential 'greenwashing' accompanying SLBs.

Ecuador's landmark debt-for-nature swap

Thematic bonds can serve as components of larger mechanisms, such as **debt-for-nature swaps.**

These have attracted the spotlight after Ecuador's successful refinancing of sovereign debt through a historic debt-for-nature swap mechanism, in which Dentons, through a multi-jurisdictional team, advised Ecuador. Ecuador resorted to this debt-for-nature swap mechanism to effectively buy back approximately $1.628bn of its then existing sovereign debt in exchange for new debt of approximately $656 million, while freeing up an additional $323 million to comply with certain agreed sustainability commitments to enhance the conservation of the Galápagos Islands and their marine ecosystems. As part of its overall financial structuring, this mechanism was associated with the issue of a blue bond ultimately connected to the goal of conserving the Galápagos.

David Syed, Head of Europe Sovereign Advisory at Dentons, explained this swap was historic, because it is the largest deal of this kind. Deals of this complexity require collaboration across jurisdictions and diverse expertise. Syed clarified that Dentons specialists from the Banking and Finance, Capital Markets, Sovereign Advisory and Environmental Law practices joined forces to make it happen.

"This deal represents a unique opportunity to forward environmental sustainability while addressing sovereign financial obligations" – Syed said.

A buy-back of approximately $1.628bn in Ecuador's sovereign debt at a 60% discount makes it the largest such swap on record. This may feel like debt-for-nature swaps are a new thing. They are not. The first operations of this kind happened back in the 1980s, but they have remained relatively marginal. They are still rare, largely due to the complexity of such arrangements, among other reasons.

In the words of Ecuador's foreign minister quoted by Reuters, biodiversity has become currency – and in Ecuador's case, it was well worth the effort.[18]

At the time of closing of the transaction in May 2023, the country's sovereign bonds were yielding 17-26%. The interest rate under the new Ecuador debt resulting from that transaction was a fixed interest of 6.975%. As a result, the payments by Ecuador under that new debt slashed its cost of capital by at least two-thirds.

In exchange, Ecuador will have to implement a series of sustainability commitments to enhance the conservation of the Galápagos Islands and their marine ecosystems. The creditors would have to keep dealing with $1.6bn of presumably unsustainable debt.

In the medium and long term, everybody – not just Ecuador – will have to face mounting environmental challenges and growing investment required to mitigate the risks and adapt.

The largest debt-for-nature swap in human history is still but a drop in the (Pacific) ocean. The operation perhaps only scratches the surface of the opportunity these arrangements present.

Biodiversity and resilience on the rise

As much as green bonds remain the dominant type of thematic bonds, some sub-types attract more attention than the others.

Big banks, S&P and a few other institutions point to climate risk adaptation and biodiversity preservation as racing to the forefront of key investments. It is estimated that half of the output of the global economy depends on nature to a significant degree.

According to international bodies quoted by S&P Global, disastrous events related to weather and climate are now **five times** as frequent as they used to be over the last 50 years. The world will need $300-400bn for adaptation efforts by 2030.

Innovative bond instruments signal value of nature and its preservation, served by the world of finance. Deutsche Bank pointed out that conserving the assets of natural habitats and reducing carbon emissions are comparable in importance.[19]

Striking the right balance between the preservation of nature and the attainment of financial outcomes requires complex reporting and governance.

This is recognized by global actors, both public and private. TNFD, or the Taskforce on Nature-related Financial Disclosures, has just published the iteration no. 0.4 of its recommendation framework.

The TNFD framework[20] is intended to increase reporting standards for all investments that aim to achieve nature-specific goals. The taskforce is backed by the G7 and several representatives of financial institutions, with over $20tn in assets. The objective of the framework is to help direct global capital to investments that help nature by providing unified definitions and disclosure standards. The Climate Bonds Initiative reports that TNFD's work has already inspired more issuances targeting biodiversity protection. Sovereigns can be important actors in pushing this agenda forward.[21]

Tellingly, this inter-institutional body defines all business impacts and dependencies, as well as risks and opportunities, on the basis of their relationship to a given **biodiversity** characteristic.[22]

A thorough understanding of biodiversity risks and opportunities thus emerges as a key component of future-proof business, and the growing awareness of this topic may lead to a growing prominence of bonds targeting biodiversity.

Potential for social bonds?

Social bonds ballooned in the middle of the COVID-19 pandemic. They were the fastest growing segment of sustainable debt in 2020. Definitions vary, although it is generally assumed that social bonds help governments, as the default providers of social services, in dealing with financing challenges in this area by shifting the cost to investors: a typical characteristic of any debt, but a novelty for social matters.

The governments used them as a tool to fight the economic effects of the virus. The growth dwindled in 2022 when issuers were no longer so focused on recovery. Instead, they turned to sustainable bonds, which are more flexible and combine both social and environmental elements.

The case of COVID-19, however, shows that this kind of instrument could be used in future emergencies, and especially gender bonds can attract interest in such circumstances. As UN Women argues, women tend to be more affected by crises than men. In many countries, they have fewer resources than men and are therefore worse positioned to weather a difficult situation. Gender bonds, a subcategory of social bonds, help finance activities to mitigate this inequality.

Can we expect more debt swaps?

Can the success of Ecuador's swap inspire more similar transactions? The enthusiastic public reaction to the deal, combined with the size of the transaction, allows us to expect that the swap will further boost the standardization and reporting effort.

What is more, this is a spectacular instance of a sovereign debt instrument strongly linked to the value of preserving natural ecosystems for future generations.[23,24] So far, the majority of similar transactions have included a debt-for-nature swap, but such savings could go to various sustainable goals, not necessarily conservation.

There are examples of swaps that involved health and education—between 1989 and 1995, UNICEF acquired $189m of debt, generating $44m of funding for child development programs in eight countries.[25]

Sovereigns could pledge to allocate the capital to sustainable goals other than nature conservation so, hypothetically, we may witness the emergence of similarly structured deals, for instance, debt-for-equality or debt-for-resilience swaps, provided the activities are compliant with the relevant frameworks and succeed in attracting investors.

Imagine there is one bond

There is not one perfect thematic bond. However, the characteristics of an instrument that is demonstrably better than those available on the market today are rather clear.

Cost is the name of the game. To reduce cost, sustainable debt requires more standardization, transparency and streamlining. As we have seen above, this is where sovereign issuers and investors converge: today, both government agents and corporate investors understand that issuing an international bond takes time, resources, and is not simple enough. To advance in every step of this process is to increase savings, both monetary and otherwise.

Simpler, therefore cheaper. A simpler process requires easier labelling of bonds as thematic and budget items as eligible for financing via these bonds. This, in turn, requires a pre-established and universally followed working frameworks for all actors involved.

Cheaper means involving less resources, and this includes high-level manpower. Today, it takes entire intra- and inter-institutional committees to work out a proposal. Typically, several ministries take part in preparing sovereign green debt products. The bodies and committees that do it are composed of high-level staff.

Fewer people involved in a simpler process means the job is done more quickly. According to different estimates, it now takes about half a year (minimum) for all the cogs to turn and spit out a finished thematic debt product.[26]

A perfect match between the issuers' and the creditors' interests... Sovereign thematic bonds help investors to diversify their portfolios while showing the commitment of states to sustainable investment: the match is here.

...with clearly eligible expenditures and reporting. Green bond criteria do not translate directly into actionable rights for investors. This risks putting them at a loss (depending on each contract). The 'green' adjective of both expenditure and proceeds depends largely on the issuer's definition, which allows us to circle back to the need of a universal framework.[27]

The markets recognize that these products are dynamic and will evolve further. Increasing investor rights would be a large step forward; however, investors must be open to innovation so that sovereign issuers may seek funding by thinking out of the box.

For example, while today we might think of a green or blue bond to protect a deep sea ecosystem, in the future, that definition may be expanded to include a social, green and sustainability bond that protects an ancient waterway and adding a desalination plant, thereby protecting cultural heritage, reducing pollution to the sea, and ensuring access to fresh water.

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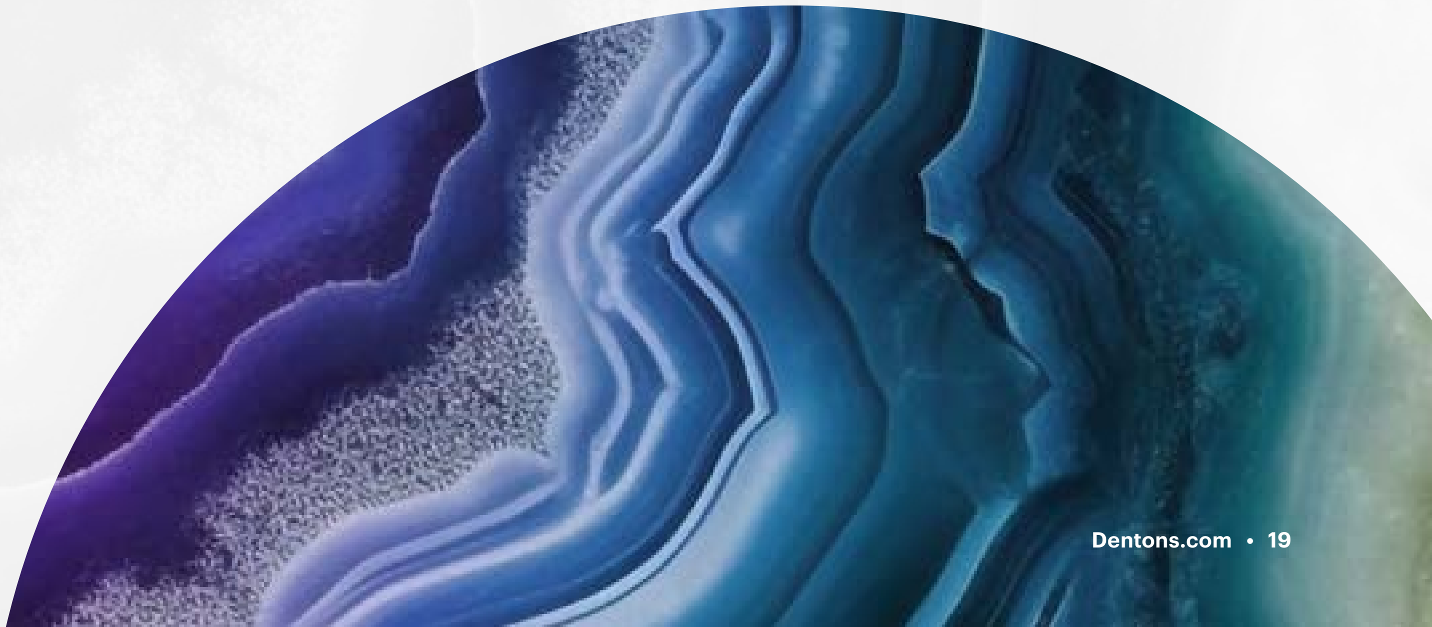

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